In the Supreme Court of the United States

OCTOBER TERM, 1973

PACIFIC TRANSPORT COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The Memorandum Findings of Fact and Opinion of the Tax Court (Pet. App. C) are unofficially reported at 29 T.C.M. 133. The opinion of the court of appeals (Pet. App. B) is reported at 483 F. 2d 209.

JURISDICTION

The judgment of the court of appeals was entered on August 16, 1973. A petition for rehearing was

denied on September 10, 1973. The petition for a writ of certiorari was filed on December 5, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the payment by a parent corporation of contested liabilities of a wholly-owned subsidiary, whose assets the parent had obtained (and whose liabilities it had assumed) by liquidating the subsidiary under Sections 332 and 334(b)(2) of the Internal Revenue Code of 1954, was properly required to be capitalized so that the amount of the liability paid was added to the parent's cost basis in the subsidiary's assets.

STATUTES AND REGULATIONS INVOLVED

Sections 165, 332, 334(b)(2), 368(a)(1), 381(a) and 381(c)(16) of the Internal Revenue Code of 1954 and Treasury Regulations, Section 1.334-1, are set forth at Pet. App. A 1-12.

STATEMENT

Petitioners are affiliated corporations which filed consolidated returns during 1956-1959. In 1959, one of petitioners discharged an obligation incurred by its former subsidiary. The payment was claimed as a loss deduction on the 1959 consolidated return and carried back to the years 1957 and 1958. The propriety of that deduction is the sole issue raised in the petition.

The pertinent facts are as follows: In July 1956, States Line, Inc. ("New States") acquired by purchase all of the stock of States Steamship Company ("Old States"), from Blyth and Company, for $11,050,000 in cash.[1] D. R. Dant, the sole shareholder of New States, intended to have New States liquidate Old States and obtain its assets within two years in order that New States' basis in Old States' assets would be equal to the purchase price of the stock, as prescribed by Section 334(b)(2) of the Code. Old States was accordingly liquidated on June 30, 1957, and New States thereby acquired its assets (including its name) and assumed its liabilities pursuant to Section 78.540 of the Revised Statutes of Nevada (Pet. App. B 15-17).

Among the liabilities of Old States assumed by New States were certain claims then being prosecuted against Old States by shippers in connection with the loss of cargo aboard the S.S. PENNSYLVANIA, a cargo ship owned and operated by Old States when, it was lost at sea in 1952. At the time of New States' purchase of Old States' stock, a judgment had been entered against Old States limiting its liability under 46 U.S.C. 183(a) to the amount of pending freight charges, which was less than its insurance coverage.

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[1] New States' acquisition of the stock of Old States was part of a larger transaction in which all of the stock of Old States' former parent corporation, Dant and Russell, Inc., was sold by members of the Dant family to Blyth and Company, which immediately liquidated Dant and Russell, Inc., and sold the stock of Old States to the newly-organized New States (Pet. App. B 15-16).

On rehearing, however, the court of appeals held that the liability for the loss of cargo could not be so limited.[2] On remand, the claims were settled in 1959 with a payment by New States of $1,455,394 to the shippers (Pet. App. B 17-18).

In their 1959 consolidated return, petitioners claimed the amount paid by New States in satisfaction of Old States' liability to the shippers as a casualty loss deduction. The Commissioner disallowed the deduction on the ground that the payment represented part of the acquisition cost of the Old States' assets. As a result, the payment was not currently deductible but was part of New States' basis in those assets (Pet. App. B 19).

The Tax Court upheld petitioners' claimed deduction because "the liability * * * was so speculative that it cannot fairly be regarded as part of the 'cost' of the assets acquired" (Pet. App. C 96). The court of appeals reversed, however, holding that pursuant to Section 334(b)(2) of the Code, New States' payment could not be currently deducted but was to be added to its basis in the acquired assets (Pet. App. B 19-23).

ARGUMENT

1. Section 332 of the Code provides as a general rule that no gain or loss shall be recognized by a parent corporation upon the receipt of property distributed in complete liquidation of an 80 percent-

[2] See *States Steamship Co.* v. *United States*, 259 F. 2d 458 (C.A. 9), opinion on rehearing, 259 F. 2d 463.

owned subsidiary. In such a tax-free liquidation, Section 334(b)(1) provides a carryover basis rule so that the parent's basis in the assets of the liquidated subsidiary is equal to the subsidiary's basis in the assets. Section 334(b)(2) provides, however, that where, as here, at least 80 percent of the stock of the subsidiary was acquired by purchase during a period of not more than 12 months and a distribution of the subsidiary's assets is pursuant to a plan of complete liquidation adopted not more than two years after such purchase, the parent's basis for the property acquired in the liquidation of the subsidiary is the parent's cost of the subsidiary's stock, with certain adjustments.

Among the adjustments specifically provided for under Section 334(b)(2) is that the parent's basis in the assets of its liquidated subsidiary is to be increased by any liabilities of the subsidiary which the parent assumes on the liquidation.[3] See Treasury Regulations, Section 1.334-1(c)(4). No distinction is made between fixed and contingent liabilities. Here, at the time New States acquired the assets of Old States, it assumed all of Old States' liabilities. Since Section 334(b)(2) was applicable,[4] the court of ap-

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[3] Section 381 of the Internal Revenue Code, which otherwise provides for the carryover of the tax attributes of liabilities assumed by the parent on a Section 332 liquidation (see Section 381(c)(16)), specifically excepts from its operation those liquidations, such as that here, to which Section 334(b)(2) applies (Section 381(a)(1)).

[4] Section 332, by the terms of Section 332(b) (last sentence) and therefore Section 334, governs the liquidation of a sub-

peals correctly held that the payment made by New States in discharge of Old States' cargo loss liability was to be added to New States' basis in the assets acquired by it.

2. The court of appeals correctly recognized the relevance of this Court's decisions in *Woodward* v. *Commissioner*, 397 U.S. 572, and *United States* v. *Hilton Hotels*, 397 U.S. 580. In those cases, the Court held that appraisal expenses incurred in connection with the acquisition of the stock of dissenting stockholders were nondeductible capital outlays which were part of the cost of acquiring the shares of dissenting stockholders. Such costs therefore had to be added to the purchaser's basis in the shares. The expenditures were deemed to be capital because they arose out of the acquisition of the dissenters' shares. Cf. *Arrowsmith* v. *Commissioner*, 344 U.S. 6; *United States* v. *Skelly Oil Co.*, 394 U.S. 678. This case similarly involves the principle that a payment made in connection with the acquisition of property must be added to the cost basis in the property. The payment here arose out of a capital transaction. The assumption of Old States' liabilities as required by Nevada law was a direct consequence of its liquidation and the acquisition by New States of its assets.

The fact that the purchase price of Old States' stock was not reduced to reflect the cargo loss lia-

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sidiary into a parent even though the liquidation is by merger of the subsidiary into the parent. *Kansas Sand and Concrete, Inc.* v. *Commissioner*, 462 F. 2d 805 (C.A. 10); *American Mfg. Co.* v. *Commissioner*, 55 T.C. 204, 219-220.

bility does not require a result different from that in *Woodward* and *Hilton*.[5] Petitioners were well aware of the possibility of an adverse judgment with regard to that liability, although their attorney believed that the likelihood thereof was small (Pet. App. B 18, 20). New States' assumption of that liability, by virtue of the subsequent liquidation of Old States, reflects the price it was willing to pay to acquire the assets of Old States. *Magruder* v. *Supplee*, 316 U.S. 394, 398. Nothing in *Woodward* and *Hilton* suggests that an exception to capital treatment should be made where the purchaser enters into a bad bargain or where he misappraises the likelihood of having to pay an assumed liability.[6]

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[5] The Tax Court (Pet. App. C 86-96) found that the cargo loss liability was not reflected in the purchase price. On this ground, it held that the item was not required to be added to basis under Section 334(b)(2). But as the court of appeals observed (Pet. App. B 21), there is no exception to the fundamental principle reaffirmed in *Woodward* and *Hilton Hotels* for contingent liabilities incurred in connection with the acquisition of property. All expenditures in connection with such an acquisition are to be added to the purchaser's cost basis even though they may not be explicitly reflected in the purchase price.

[6] Petitioners also err in arguing (Pet. 16-19) that the decision below conflicts with the annual accounting concept as reaffirmed in *Commissioner* v. *Gordon*, 391 U.S. 83, 96. There, the Court rejected a claim to tax-free treatment for a spin-off under Section 355 because it was uncertain when the taxpayer would, if at all, complete the required stock distribution. Petitioners contend that they should not be required to make the required basis adjustments because of the uncertainty as of the liquidation whether the assumed liability of Old States would have to be paid. The cases are, however, com-

3. Contrary to petitioners' contention (Pet. 6-11), review in this case is not necessary to determine the continuing vitality of *Helvering* v. *Metropolitan Edison Co.*, 306 U.S. 522. In that case, this Court held that after a merger of two or more corporations the surviving corporation might continue to take deductions for unamortized discount with respect to bonds originally issued by the merged corporation. If this case had arisen prior to the enactment of the 1954 Code and the new provisions of Sections 334(b)(2) and 381, that decision might have been relevant, though by no means necessarily controlling. *Metropolitan Edison* has never had the universal applicability to deductions generally that petitioners would ascribe to it, and it is not controlling here.

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pletely different. In *Gordon*, the Court held that the tax treatment of a stock distribution already made could not await a further distribution in a subsequent year when it was not clear that the second distribution would be made. Here, the required basis adjustment for liabilities assumed does not delay resolution of the tax treatment of an amount previously received or paid out.

Moreover, the existence of possible allocation problems does not convert a non-deductible capital expenditure into a current deduction. The basis of the assets is simply increased by the amount of the claim ultimately paid in proportion to their relative fair market values on the date of purchase of the stock. See Treasury Regulations, Section 1.334-1(c)(4)(vi) and (vii). Even if petitioners had sold some of the assets prior to the payment of the claim, which was not the case, the basis adjustment could easily have been made to the remaining assets. *Bermont Oil Co.* v. *Helvering*, 91 F. 2d 710 (C.A. D.C.). And if all of the assets had been sold, the payment could be treated as a capital loss. *Rees Blow Pipe Mfg. Co.* v. *Commissioner*, 41 T.C. 598, affirmed *per curiam*, 342 F. 2d 990 (C.A. 9).

Because of the uncertain scope of diverse court decisions,[7] Congress enacted as part of the 1954 Code Section 381, a comprehensive statutory system dealing with "Carryovers in Certain Corporate Acquisitions." H. Rep. No. 1337, 83d Cong., 2d Sess., p. 41. That section contains a list, now numbering 23 items (Section 381(c)), of tax attributes which are subject to carryover in the types of transactions set forth in Section 381(a) and (b). However, as we have noted (n. 3, *supra*), Section 381(a)(1) expressly excludes from the instances where carryovers are permitted this very case—"a case in which the basis of the assets distributed is determined under section 334(b)(2)."

The exclusion of liquidations governed by Section 334(b)(2), such as this case, from the operation of Section 381 was necessary because Section 334(b)(2) treats the purchase of stock, followed by a liquidation as there specified, as a purchase of the underlying assets and attributes to those assets a basis equal to the cost of the stock adjusted, *inter alia*, for "any liabilities assumed or subject to which the property was received."[8] Thus, whatever force *Metro-*

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[7] See, *e.g.*, *New Colonial Co.* v. *Helvering*, 292 U.S. 435; *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382.

[8] Sections 334(b)(2) and 381 are well coordinated and fully consistent with one another in this regard. The former adds the liability of a liquidated subsidiary, necessarily assumed by the parent, to the cost or basis of the assets received, while the latter excludes such liquidations from its operation, thereby denying the possibility of a deduction to the parent by way of a carryover of a tax attribute. To permit a deduction

politan Edison Co. might otherwise have had here, the rule in that case must necessarily yield to the statutory solution provided by Congress in Sections 381 and 334(b)(2).[9] As a leading text has stated: "Section 381 does not apply, however, to corporate divisions, recapitalizations, or insolvency reorganizations, or to some transfers of property to controlled corporations under § 351; these transactions [none of which is involved here] remain subject to the pre-1954 rules dealing with the preservation of corporate tax attributes. As a result, the *New Colonial Ice*, *Libson Shops*, and *Metropolitan Edison* lines of authority retain a limited viability under the 1954 Code." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (1971 ed.), p. 16-17.

4. There is no conflict betwen the decision below and those of other appellate courts. Petitioners' reliance (Pet. 11-12) on *United States* v. *Minneapolis & St. Louis Railway Co.*, 260 F. 2d 663 (C.A. 8), is misplaced. That case did not involve the liquidation

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under Section 381 where Section 334(b)(2) is operative would be to give double effect to the same outlay, a result plainly proscribed by the statute. Cf. *United States* v. *Skelly Oil Co.*, 394 U.S. 678.

[9] Petitioners contend (Pet. 7, n. 9) that the Court in *Hilton Hotels* has preserved the vitality of *Metropolitan Edison* by its statement (397 U.S. at 585) that "The debts which Hilton inherited from Waldorf retained their capital or ordinary character through the merger." But *Hilton Hotels* did not focus upon the question whether the transaction was a Section 332 liquidation or, if it was, whether the basis of the acquired Waldorf assets was to be governed by Section 334(b)(1) or 334(b)(2).

of a subsidiary, and in any event arose prior to the enactment of Sections 334(b)(2) and 381 in 1954. In addition, the factual situation was significantly different.

In *Minneapolis*, a successor corporation was permitted to deduct payments in settlement of a labor dispute which had arisen prior to its acquisition of its predecessor's assets, even though the settlement provided for a retroactive wage increase. But the liability there involved was not one which was incurred by the predecessor company and assumed or paid by the successor, but rather arose from a new obligation incurred by the successor corporation after it took over the business of its predecessor. Here, however, the liability was incurred by Old States, and arose long before New States was even organized. In this situation, the Eighth Circuit has taken the same view that the court of appeals took here. *Holdcroft Trans. Co.* v. *Commissioner*, 153 F. 2d 323, 324. Accord: *W. D. Haden Co.* v. *Commissioner*, 5 T.C.M. 250, affirmed on this issue, 165 F. 2d 588 (C.A. 5).[10]

Similarly, petitioners' assertion (Pet. 20-21) of a conflict between the decision here and *American Potash & Chemical Corp.* v. *United States*, 399 F. 2d

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[10] Nor is review necessary here, as petitioners contend (Pet. 13-16), to clarify the applicability of the carryover rules of Section 381(c) and prior law to transactions not specifically enumerated in Section 381(a). There is no need for clarification in a case to which Section 334(b)(2) applies, since the statute specifically provides that the payment of assumed liabilities is to be added to the basis of the acquired assets.

194, 402 F. 2d 1000 (Ct. Cl.) is erroneous. That case simply stands for the proposition that even though a liquidation does not satisfy the technical requirements of Section 334(b)(2),[11] the parent's cost basis in the subsidiary's assets will nevertheless be equal to its cost for the subsidiary's stock as long as the parent purchased the stock with a view to acquiring the subsidiary's assets. In so holding, the Court of Claims applied the rule of *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718 (C.A. 5), certiorari denied, 342 U.S. 827. There, the Tax Court treated the purchase by one corporation of the stock of another corporation, closely followed by the liquidation of the newly acquired subsidiary, as a purchase of assets. It thereby held that the basis of the assets was equal to the cost of the stock because the stock was purchased for the purpose of acquiring the assets.[12]

Here, however, there is no dispute that all the objective criteria of Section 334(b)(2) were satisfied and *American Potash* is thus totally inapplicable. Neither *American Potash* nor *Kimbell-Diamond* address the question whether an assumed and paid liability of a liquidated subsidiary is added to the par-

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[11] There, a corporation acquired the requisite amount of stock of another corporation over a 14-month period, while Section 334(b)(2) requires acquisition of the stock over a 12-month period.

[12] While Section 334(b)(2) essentially codifies the *Kimbell-Diamond* rule, the statute eliminates the subjective intent upon which that doctrine is founded.

ent's basis in the assets. Where, as in this case, the requirements of Section 334(b)(2) are undisputably satisfied, that provision expressly requires that the basis of the assets acquired is equal to the cost of the stock plus any assumed liabilities of the liquidated subsidary.[13]

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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FEBRUARY 1974.

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[13] Nor is there any conflict with the cases relied upon by petitioners (Pet. 22-23) for the proposition that tax statutes are not to be literally interpreted where the result would be inequitable. There is nothing inequitable in requiring purchasers to capitalize expenses incurred in acquiring property.

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